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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

Foreign Countermeasures to Dollar Depreciation: A Little-Used Strategy

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ER IM 73-58
September 1973

Copy No. 87

Approved For Release 2006/04/19 : CIA-RDP85T00875R001700050055-5

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Foreign Countermeasures to Dollar Depreciation: A Little-Used Strategy

Foreign countermeasures to offset the impact of the dollar's depreciation on countries' trading positions so far have been minor. The foreign response has been limited to scattered criticism of US policy, a few European and Japanese moves designed to soften and slow the impact, particularly for politically sensitive industries, and in some cases, a tougher stand on trade and monetary reform issues.

Reactions generally have been restrained because the effect of the currency changes on the trade performance of the major appreciating currency countries has been small, and burgeoning domestic demand abroad has been adequate to compensate for any losses in foreign sales. The natural lag in the impact of exchange rate changes on trade, the fact that the faster rise of US than of foreign export prices in domestic currency has offset much of the depreciation of the dollar, and the relatively small role of US trade in the total foreign trade of most countries have all tended to minimize the impact on major foreign economies.

Countermeasures will receive more of a hearing as major US trading partners see their surpluses shrink, but even then the political obstacles to such action probably would make foreign capitals turn first to monetary steps.

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Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted] the Office of Economic Research, [redacted]

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DISCUSSION

Dollar Depreciation

1. The dollar has depreciated substantially in 1973 (see Table 1 and the chart). It was devalued 10.0% on 12 February and subsequently depreciated against most of the major floating currencies. Although strengthening somewhat in August, the dollar has still declined since 2 January by more than 23% relative to the German mark, about 15% relative to the other European currencies participating in the joint-float, and almost 12% relative to the Japanese yen. Among the major currencies, only the British pound, the Canadian dollar, and the Italian lira have not strengthened significantly relative to the dollar.

Foreign Reaction to Dollar Depreciation

2. Foreign reaction to the dollar's further depreciation this year has been mixed. The February devaluation was generally viewed favorably, although there were some complaints that Washington acted precipitously. Foreign concern increased, however, after the monetary crises in late February and early March and the subsequent depreciation of the dollar against the joint-float currencies – particularly the sharp depreciation in July. Most of the concern was that US policies were upsetting the international monetary system, although France and Japan were concerned in addition about the potential damage to their trade balances.

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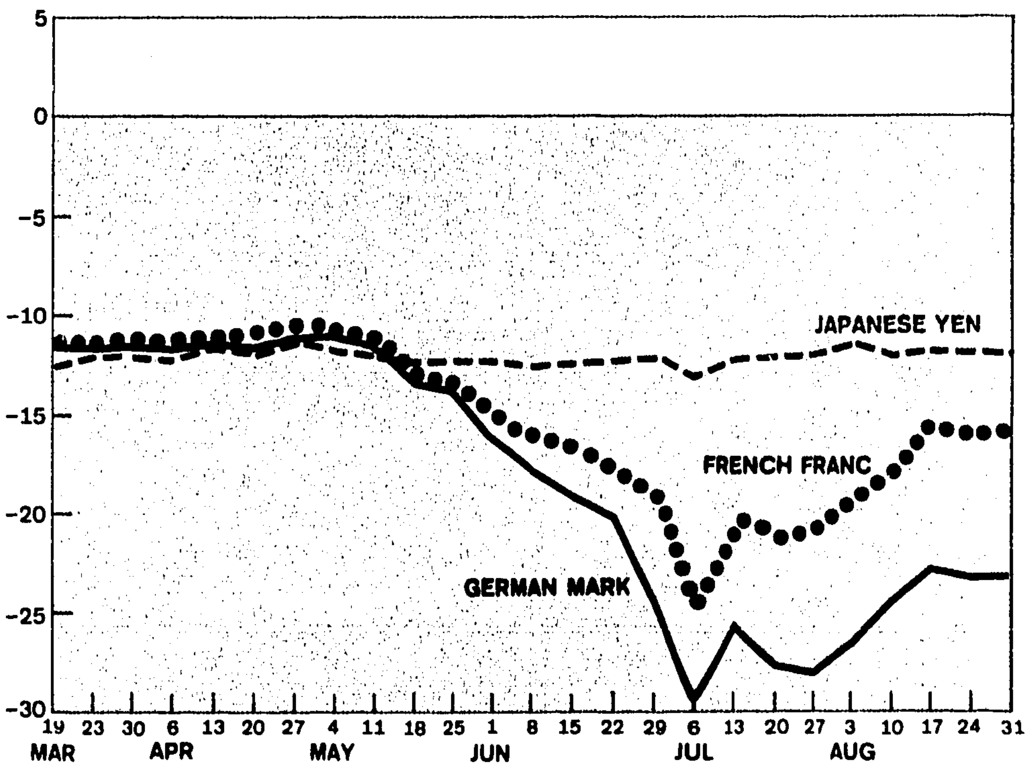
Table 1

Percent Change Since 2 January 1973 in the Value of the US Dollar Relative to Selected Foreign Currencies

	19 Mar	1 Jun	6 Jul	31 Aug
German mark	-11.80	-16.61	-29.24	-23.23
Swiss franc	-13.86	-18.54	-28.02	-19.53
French franc	-11.38	-15.27	-24.74	-15.79
Belgian franc	-10.14	-13.73	-22.16	-14.70
Japanese yen	-12.69	-12.47	-13.20	-11.92
British pound	-4.62	-8.76	-8.31	-4.53
Italian lira	-3.14	-0.72	-1.35	-3.14
Canadian dollar	+0.15	-0.05	+0.15	+0.93

PERCENT CHANGE SINCE 2 JANUARY 1973 IN THE VALUE OF THE US DOLLAR RELATIVE TO SELECTED FOREIGN CURRENCIES



4. Tokyo was surprised by the extent and timing of the February devaluation. Japanese firms had long anticipated a second yen revaluation, but were hoping to delay such a move until the summer of 1973 and limit it to about 10%. Of particular concern to the business community was Prime Minister Tanaka's decision to allow the yen to float -- Tanaka was forced to apologize to the Diet for this unexpected move. Since the initial appreciation in February and March, however, the yen's value has been remarkably stable despite the dollar's decline relative to the joint-float currencies. In fact, the central bank has been forced to intervene in the exchange market and support the yen to prevent too sharp an improvement in Japanese competitiveness relative to the participants in the European joint float.

Foreign Government Countermeasures to Dollar Depreciation

5. Despite the substantial dollar depreciation in 1973 -- on top of the Smithsonian currency realignment of December 1971 -- foreign governments' countermeasures to neutralize the effect of these currency changes on their trade balances have been minor. No new tariff restrictions or nontariff barriers have been imposed in any developed country against US goods, and no major export subsidy or tax incentive schemes have been implemented.

6. The few measures taken to soften and slow the adverse impact of the dollar's depreciation, particularly for politically sensitive industries, include the following:

- Austria has reduced the value-added tax on capital goods purchased by export industries by two percentage points through 1975. This is expected to save these industries approximately $15 million. A refund of a portion of the value-added tax collected on previously purchased capital goods will result in a $5 million windfall for exporters. Vienna is also increasing the percentage rebate to exporters who have insured their foreign receipts against default.

- France has liberalized the regulations governing official exchange rate guarantees for exporters. The guarantees will now also be available for long-term contracts. Moreover, a 2.25% parity change -- instead of the 3% previously required -- will trigger the compensation mechanism. Paris has also dropped the requirement that exporters must receive payment from their customers within 120 days. In addition, government credits for exports have been expanded.

- Japan has allowed its program of voluntary export restraints to lapse. The program, which covered 20 major export items, was instituted last year in an effort to forestall another yen revaluation and reduce the Japanese trade surplus. Earlier this year, Tokyo had considered extending the program beyond its original one-year term, but the substantial dollar depreciation (and reduced trade surplus) led the government to dispense with the restraints on schedule. The program apparently had little effect on Japanese trade.

- Japan has also assisted smaller exporters by making forward exchange rate cover available to them at a 2%-4% discount below market rates. It also has offered to lend up to $1 billion to these firms to facilitate their adjustment to the currency realignments. Moreover, small and medium-sized firms with government loans outstanding will be allowed a one-year grace period on repayment. In addition, Tokyo presumably will continue the policy instituted after the last realignment, which allows a tax rebate to the shipbuilding industry for losses on dollar-denominated contracts. Tokyo also has decided not to implement a number of specific tariff reductions -- reductions that had been under consideration for some time.

7. Other nations reportedly are considering similar countermeasures:

- Belgium is considering increasing the funds available for export promotion and for underwriting export credits.

- Norway has proposed a program of interest-free loans and tax refunds to compensate exporters for losses on dollar-denominated contracts.

- Sweden is planning a new, more competitive export credit program.

Factors Behind the Limited Countermeasures

8. Most countries have not yet felt a need to introduce strong countermeasures to offset the impact of dollar depreciation because the effect of the currency changes on overall trade performance has so far been small and because burgeoning domestic demand has been adequate to compensate for any losses in foreign sales. Certain countries with appreciating currencies had larger trade surpluses in the first half of 1973 than in the first half of 1971 or 1972 (see Table 2). The West German

Table 2

Selected First Half of Year Trade Balances[1]

			Million US $
	1971	1972	1973[2]
West Germany	3,207	4,193	6,507
Switzerland (Jan-Mar)	-285	-303	-393
France	511	449	612
Belgium (Jan-Mar)	105	111	98
Japan	3,752	4,349	2,862

1. Seasonally adjusted, f.o.b./f.o.b.
2. Preliminary.

trade surplus in the first half of the year, for example, was a record $6.5 billion, compared with $4.2 billion in the first half of 1972. Although the Japanese trade surplus declined from the very high 1971 and 1972 levels, this probably was as much a consequence of renewed rapid growth in Japan as of dollar depreciation.

9. One reason the dollar's depreciation has had little or no effect on countries' overall trade balances is that divergent export price trends in terms of national currency have offset much of the exchange rate change (see Table 3). Between May 1972 and May 1973 (the latest period for which reliable, internationally comparable data are available), US export prices increased nearly 14%. West German export prices in national currency increased less than 3% in the same period, and prices in dollars only about 18%. The gain in US price competitiveness relative to West German exporters consequently does not equal the full extent of the mark's appreciation over the period -- 15% -- but less than one-third as much -- 4%. Similarly, differences in export price movements between the United States and Switzerland have neutralized about two-thirds of the Swiss franc's appreciation. In the case of Japan and France, roughly one-half of the change in currency values has been neutralized.

10. Another reason for the small impact on trade balances is that most countries are less affected by changes in the dollar exchange rate than by changes in the exchange rate with third countries, inasmuch as most of these countries' trade is not with the United States (see Table 4). In the case of West Germany, for example, less than 10% of total trade is with the United States, and about 40% is with countries whose exchange

Table 3

Changing Price Competitiveness
May 1972 to May 1973

Percent

	Exchange Rates (National Currencies Relative to the Dollar)	Unit Export Prices	
		In National Currency	In Dollars
United States	....	13.7	13.7
West Germany	15.3	2.3	18.0
Switzerland[1]	16.0	2.2	18.6
France[2]	10.8	8.3	20.0
Japan	15.2	4.2	20.0

1. First quarter 1972 to first quarter 1973.
2. March 1972 to March 1973.

Table 4

Selected US Trading Partners' Trade with the United States and the European Community as a Share of Total Trade, 1972

Percent

	United States	EC of Nine
West Germany	8.8	50.2
Switzerland	7.7	58.8
France	6.7	60.0
Belgium	5.8	72.7
Japan	28.5	10.1

rates are tied to the mark through the operation of the European joint float. Although the mark has appreciated about 30% relative to the dollar since 2 January, it has appreciated only about 14% relative to the currencies of all of Germany's trading partners (see Table 5). France is even less affected by dollar depreciation than is Germany, as only about 7% of its trade is with the United States and almost half is with countries participating in the joint float. The franc has appreciated about 18% relative to the dollar since 2 January, but only about 2% relative to the currencies of all major trading partners.

Table 5

Selected Trade-Weighted Exchange Rates

	Percent Change from 2 January 1973			
	19 Mar	1 Jun	6 Jul	31 Aug
German mark	+3.86	+6.59	+16.86	+13.61
Swiss franc	+6.08	+8.63	+13.26	+6.58
French franc	+3.32	+5.17	+7.55	+2.09
Belgian franc	+0.47	+1.19	+1.12	-1.05
Japanese yen	+9.90	+8.43	+7.27	+7.60

11. The impact of currency changes on countries' trade balances, moreover, takes place only after an adjustment lag, often of one or two years. First, there is a lag in the response of producers and consumers to new market conditions because decisions are made in light of past as well as current prices and incomes. Second, there is a delay between the time contracts and prices are negotiated and the time the merchandise enters the importing country's market.

12. The high rate of world economic growth has both reduced the impact of dollar depreciation on countries' trade balances and masked what little impact has occurred. Because of relatively rapid growth of US demand, American companies have in many cases been unable to fill new export orders on a timely basis. This apparently has impeded a European shift to US sources of supply.

13. In conditions of worldwide boom, the impact of increased US competitiveness is less apparent because burgeoning domestic demand keeps output at or near capacity (see Table 6). The domestic inflation that generally results from rapid growth also makes foreign governments more willing to accept cheaper US goods. Most West European countries are now in the expansionary phase of their business cycle. Manufacturers, instead of being hard pressed for sales, are straining to fill existing contracts. Despite the substantial appreciation of the mark, for example, German industry is still swamped by a backlog of foreign orders. French industries are also operating at capacity, and numerous companies complain of shortages of labor and capital that inhibit expansion and output growth. Japan is also in the midst of an economic boom that has all but eliminated the substantial excess capacity that emerged in 1971.

14. Other considerations also have played a role in keeping foreign countermeasures to dollar depreciation at a minimum. Tokyo, for example, was already under pressure to reduce its trade surplus with the United States

Table 6

Real GNP Growth in Selected Countries

	Percent Change at Annual Rate			
	Jul-Dec 71	Jan-Jun 72	Jul-Dec 72	Jan-Jun 73
United States	3.7	7.3	7.5	6.9
West Germany	-1.3	5.8	1.2	11.9
Switzerland[1]	4.7	4.8	4.8	4.5
Belgium[1]	3.7	4.7	4.7	4.5
France	7.0	4.9	3.6	8.2[2]
Japan	4.6	8.5	14.6	13.2

1. Derived from annual data.
2. First quarter only.

and consequently was reluctant to attempt to offset the impact of the currency changes. Foreign governments are also conscious of the possibility of US retaliation to new trade barriers. Major US trading partners are aware, in particular, that the proposed US trade bill will enable the President to increase tariffs as well as lower them if he deems it is in the nation's interest. Japan especially wants to avoid any new restrictions on its exports destined for the US market.

Prospects

15. The currency changes are likely to have an increasing impact as adjustment lags are overtaken and as a slowdown in US growth reduces US imports and increases US export availability. An economic slowdown abroad also is in prospect, if only because of foreign governments' actions to dampen inflation. Then, the slowdown in export growth to the US market and the increase in imports because of the currency realignments will exacerbate the slowdown in foreign economies. In some countries, this will mean fewer domestic job opportunities and a substantial adjustment burden.

16. Although most US trading partners welcome an improvement in the US balance of payments as a major contribution to the international political and economic climate, they have their own ideas as to the proper extent and use of such an improvement. The Europeans want the US trade position to improve, but they do not want renewed US trade surpluses to be used to finance increased capital investment -- and, therefore, increased control over their industries. They also are unwilling to see their own trade balances eroded too much in order to improve the US trade

position. The French, in particular, fear that the recent growth in US exports suggests that there may be significant problems when the full effect of dollar depreciation is felt.

17. Countermeasures to dollar depreciation will be considered more seriously as countries' trade surpluses shrink. Even then, increased controls on capital inflows and heavier intervention in support of the dollar might seem more attractive than countermeasures aimed directly at trade, which could lead to US retaliation and a full-scale trade war.

18. The growing concern of our trading partners about the impact of dollar depreciation already has affected progress toward trade and monetary reform. It has clearly helped Paris in its insistence that the multilateral trade talks take account of the advantages Washington may gain from a depreciated dollar. This issue could become a difficult problem in the final trade bargaining. Progress toward monetary reform in the ongoing discussions under the auspices of the International Monetary Fund has also been made more difficult by foreign concern about the dollar's decline. Moreover, difficulties in these important economic negotiations will complicate political and military relations between the United States and its allies.